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SUBJECT: IMF BOARD VOTE UNLIKELY BEFORE EU DECISION

REF: A. ANKARA 5999
B. ANKARA 5835
C. ANKARA 6026
D. ANKARA 6085

Classified By: DEPUTY CHIEF OF MISSION ROBERT DEUTSCH FOR REASONS 1.4 (B) AND (D).

¶11. (C) Summary. Contrary to its expectations of concluding a letter of intent by October 26, the IMF team negotiating a new Stand-by program left Turkey having made little progress on key program components. These include: specific tax measures for 2005 (with the GOT keen on a Fund-opposed VAT rate cut); the new banking law; GOT action to save 2004 fiscal overperformance; GOT endorsement of social security reforms; reorientation of the state bank privatization strategy; business climate reforms; tax administration reform; and the amount of financing to be provided by the IMF. Although IMF staff could return November 8 if the GOT demonstrates a readiness to make progress on these issues, it seems more probable that the team would not return until after Thanksgiving, making a board vote before the December 17 EU Council decision on Turkish accession unlikely. End Summary.

¶12. (C) The morning after the IMF team left, the IMF Resrep described the very substantial work agenda still remaining before agreement could be reached on a letter of intent. While the early breakthrough on the headline targets to be included in the 2005 budget was encouraging, the Resrep drew a picture of substantial disagreement on major details in fiscal policy and much work still to be done on the structural agenda.

VAT Rate Cut Proposal in a Context of Higher Revenue Targets:

¶13. (C) Though the GOT announced a 6.5% primary surplus target for 2005 early in the mission, just before the deadline for submission of the budget to parliament (ref b), the IMF staff is still not convinced GOT tax policies will achieve this target. Note: Though Prime Minister Erdogan recently made similarly market-pleasing comments about having a 6.5% target for 2006 and 2007, Babacan told the IMF mission that the PM had said "around 6.5%," which means the out-year target may not yet be nailed down. End Note.

¶14. (C) For 2005, the budget calls for a substantial increase in total revenues in real terms, such that total public sector revenues/GDP would increase. Given that this ratio is not high compared to other countries, IMF staff accepts the principle of increasing revenues in order to finance higher public investment, a GOT priority. The problem is that, at the same time the government is targeting sharply higher revenues it wants to raise these revenues almost entirely from increases in the special consumption tax (SCT) on products like alcohol, tobacco, autos and petroleum products while cutting both corporate income tax rates and value-added tax rates from 18 to 15%.

¶15. (C) The IMF accepts the corporate income tax rate cut--it's already in the budget--but has profound philosophical differences over increasing the reliance on excise taxes like the SCT while cutting the VAT. In addition to being anti-exporter (exporters can deduct VAT taxes paid), the GOT approach risks exacerbating the difficulty of harmonization with EU tax policies. The Resrep said Turkey's current VAT rate is in line with EU averages whereas its reliance on excise taxes is excessive by EU standards. A VAT rate cut could also stimulate domestic consumption, thereby increasing the current account deficit. Finally, from a purely philosophical standpoint, IMF staff argues that it would make more sense to cut payroll taxes in order to encourage employment. (The IMF is not actually proposing payroll tax cuts because of the practical difficulty of extracting this item from a package of social security-related reforms.)

¶16. (C) The impetus for a VAT cut comes from the Prime Minister who reportedly feels the need to make a significant cut in a tax like the VAT, which he believes is resented by ordinary Turks. GOT technocrats also argue that a reduction

in the rate would help with notoriously weak compliance, whereas the IMF is not convinced a mere 3 percentage point cut will have a significant effect on revenues. Furthermore, Fund staff also believes it would be imprudent to cut rates before tax administration reforms demonstrate that they can improve compliance--otherwise the cut will result in sharply reduced revenues. The Fund is not convinced the GOT can afford the VAT cut and still hit the fiscal targets: each percentage point cut in the rate costs about 0.3% of GDP.

Saving 2004 Fiscal Overperformance:

17. (C) An additional fiscal issue concerns what to do with 2004 overperformance in the primary surplus. The GOT has not complied with a July agreement that any 2004 fiscal overperformance would be saved in order to avoid excess stimulus that would exacerbate the current account deficit. The GOT was supposed to "write over" special revenues into the general budget to prevent these revenues from being spent. Aside from partial actions just before the board vote, the GOT has continued to stall. Fund staff is taking a hard line in order to maintain IMF credibility at the outset of a new program.

Banking Law:

18. (C) The Resrep said that, thanks to Minister Babacan's intervention, BRSA Chairman Bilgin had to back down on his out-of-left-field proposal by BRSA of a completely different banking law draft that would have transferred responsibility for deposit insurance to the bankers' association. BRSA, however, continues to resist a key IMF demand arising from a recommendation of the independent commission on the Imar Bank collapse: that sworn bank auditors not have a monopoly of on-site bank inspection. Another IMF-supported commission recommendation is to organize BRSA by the bank being monitored, that would integrate off-site and on-site (i.e. sworn auditor) inspectors' work.

SDIF Role:

19. (C) Separately, the IMF and GOT are discussing modifications of the role of the Savings Deposit Insurance Fund (SDIF). The IFIs cannot accept BRSA proposals that would strip SDIF of its deposit insurance function or even the right to set deposit insurance premia, and Fund and Bank banking experts have been talking about how the SDIF will handle disposal of its asset portfolio. The Turkish side has proposed that all assets not sold in 3 years be put on the balance sheet of SDIF-owned Bayindir Bank which would then be sold off. The Resrep said the World Bank experts have found a better formula in other countries--notably Korea--in which packages of assets are put into special purpose entities which are jointly held by the SDIF and private managers. By divesting the management function to the private sector, the sales work better, but SDIF's retention of ownership allows the public sector to obtain some of the upside of asset sales. The Resrep said SDIF management is considering this approach, and has generally made a better impression on the IMF than has BRSA.

State Bank Privatization:

10. (C) The Resrep also confirmed that the IFI's were reopening some of the issues regarding State Bank privatization. Fund staff is wondering whether it is realistic to target privatization--especially of Ziraat Bank--within the program's three-year time frame. Instead, the emphasis should be on the GOT doing a better job of managing the state banks in the transition period and ensuring a level playing field with private banks, to avoid state banks distorting the market. The IFIs question a central element of the study on state bank privatization prepared by McKinsey for the Treasury and World Bank: acceptance of state banks' rapidly growing their loan portfolios to replace their large government securities holdings. The IFI's would like to take a harder look at possibly selling pieces of Ziraat's branch network and/or narrowing Ziraat's role to merely taking deposits and holding government debt rather than considering it a full-fledged bank. Babacan seemed open to some of these ideas, but the Resrep admitted that state bank privatization issues were very much in flux.

Social Security Reform:

11. (C) The Social Security Reform, according to the Resrep, is currently under discussion in the Council of Ministers. While the Fund thought the specifics proposed by the High Planning Council were broadly acceptable, World Bank experts thought they needed tightening. Meanwhile, the Resrep said

he understands there was some controversy in the Council of Ministers' discussion, probably in the areas that will require either increased revenue or reduced benefit. What with the current Social Security system bleeding red ink and unsustainable, clear GOT endorsement of the Social Security reforms will be needed for the IMF program.

Privatization and Business Climate:

¶12. (C) The GOT and Fund staff have yet to work out privatization benchmarks for the program, nor have they agreed on specific measures to improve the business climate. The Resrep did not seem to be aware of the increased likelihood that the GOT will create an importers' association (or a foreign trade association) that holds the potential to become an additional barrier to trade.

Tax Administration Reform:

¶13. (C) Because of the importance of broadening the tax base, by capturing the unregistered economy and improving collections, the IMF will need to secure a clear GOT endorsement of the draft Tax Administration reform law. The law is stuck in the Prime Minister's office. There is reportedly a disagreement between the Prime Ministry Undersecretary and the Ministry of Finance over the law, though the Resrep was not sure whether the Prime Minister was involved or exactly what the differences were. The Prime Ministry U/S reportedly has issues with the structure of the tax administration.

Amount of IMF Financing:

¶14. (C) Critically, the IMF and GOT do not agree on how much financing the IMF should provide. The Resrep said that calculations of the financing gap are hyper-sensitive to the projected rollover rate for government debt in the domestic market. He said the debate centers on whether the rollover rate should be 92 versus 93 percent. Even this single percentage point results in the IMF either financing the bottom of the notional range or, as the GOT advocates, the top. Note: We understand the board-discussed range is from \$7.6 billion to \$10.9 billion End Note.

Timing:

¶15. (C) Fund staff views the ball to be in the GOT's court and have stressed that the IMF will not return until the GOT shows that it is serious about concluding a draft letter of intent. If the GOT takes sufficient action, staff will come the week of November 8. Otherwise, staff is not inclined to come to Turkey until after the November 12-16 Bayram holiday and after Thanksgiving. In that scenario, the Resrep said it would be too late to have a board meeting before the EU Council's December 17 meeting at which it will decide whether to give Turkey a date for accession negotiations. Given Managing Director Rato's desire to chair the Turkey board meeting, the Resrep said this would put the Board vote into January. If, as some believe, it is important to the EU process to have an IMF deal in hand before December 17, the Resrep wondered whether agreement with staff and Fund management on a LOI would not be sufficient. In the interim, the Resrep and a Turkish Treasury debt management official separately expressed the opinion that there was no financing need for new IMF money for the remainder of 2004.

Comment:

¶16. (C) The GOT has its work cut out for it. These are major areas of disagreement and major work remains to be done. The GOT claims and wants ownership of the reform agenda, but does not pursue the policy framework except under IMF urging. We repeatedly see it adapting to IMF requirements, at least technically, when backed in a corner. Though Babacan purports to be fully on board, the Resrep said they keep getting signs of an absence of urgency on the part of other GOT leaders, especially Unakitan. Before the sudden, unexplained turnaround on the 6.5% fiscal target for example, the Resrep said the mission had warned IMF Management that the GOT seemed to be returning to earlier "non-starter" policies, such that the IMF had even wondered if the GOT really wanted a new program. In the end, agreement is likely to be reached only if and when the GOT feels a sense of urgency under pressure from partners, the markets or financing requirements. It is likely to take time and be difficult. It is not clear to us whether the December 17 EU summit is an effective end-date to induce acceptance of needed performance measures.

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